Economic Update

Sydney | 18-09-17

September 2017

Outlook for Investment Markets

World financial markets have become less concerned about North Korean risk: equities have largely recovered from previous setbacks, and "safe haven" buying of government bonds has eased back. Whether the more relaxed mood is warranted remains to be seen. On the economic front, the world business cycle continues to improve, providing a generally good backdrop for corporate profits, though partly countered by some major central banks readying to remove some of their previous monetary policy support. Valuations generally remain on the expensive side by historical standards. Although there are hints of improvement, there is still no strong evidence the Australian economy has broken out of its period of slower than usual growth, which will be a precondition for better returns from local equities and property.

Australian Cash & Fixed Interest — Review

Yet again, short-term interest rates have remained unchanged, with the 90-day bank bill rate continuing to trade at around 1.75%. The stability reflects the unchanged stance of monetary policy, with the Reserve Bank of Australia, or RBA keeping the target cash rate at 1.5% at its most recent policy decision on September 5. Somewhat oddly, the normal pattern of longer-term interest rates following the evolution of U.S. bond yields has broken down in recent weeks. In the U.S., yields fell in later August and early September on "safe haven" buying by investors concerned about North Korea, but have risen again more recently as investors became less uncomfortable-although at time of writing, another North Korean missile firing may reignite the demand for bonds. Locally, however, there was very little variation in the 10-year Commonwealth bond yield, which was trading around 2.6% in early August, and was only marginally lower (at 2.55%) on September 8 when global fears were at their height. It has since moved back up to 2.7%. The Australian dollar has strengthened year to date in overall trade-weighted value. It has been particularly strong against the globally weak U.S. dollar—at its current USD 0.80, it is up 10.6% year to date—but it has also appreciated against most other major currencies other than the recently resurgent euro. Overall against its trade-weighted basket of currencies, the Australian dollar is up 4.5%.

Australian Cash & Fixed Interest — Outlook

The official policy decisions have said little about the prospect of any interest rate moves by the RBA. As per previously, the latest September decision said monetary policy was continuing to support the economy, that inflation would rise into the RBA's target range in due time, and consequently, there was no pressing case to do anything. In August, however, the RBA governor had said market views of an eventual interest rate rise were "reasonable assumptions," and since then—particularly in light of the unexpectedly strong rise in employment in August—market views have firmed even further. The futures market is now predicting a 0.25% increase in the cash rate by next March, and another one by the end of next year. Whatever the eventual timing, savers with money in the bank will be waiting some time for even slightly better returns, as it will likely be six months before savers see the first 0.25% improvement in yields.

As in other bond markets, expectations about higher bond yields are being pared back. Yields are still expected to rise, but inflation virtually everywhere (other than in the U.K.) has been turning out to be lower than growing economies would normally generate, for reasons still not clearly understood. Central banks are consequently expected to go on giving monetary stimulus, to get inflation back up to where they would like it to be, for longer than previously thought—as noted above, the earliest RBA move is still six months away—and both short- and long-term rates are likely to rise more slowly than previously anticipated. Forecasters now typically have quite modest expectations for a rise in Australian government bond yields. For example, by the end of next year, the Commonwealth Bank thinks the 10-year rate will be only marginally higher than currently, at 2.8%, and Westpac has it only a little higher

again, at 3.0%. National Australia Bank thinks the rise could be a bit more, to 3.4%. Either way, it looks as if it will now take some extended period before yields start returning to more normal levels.

The RBA has been using the same wording in its past few policy decisions: "An appreciating exchange rate would be expected to result in a slower pick-up in economic activity and inflation than currently forecast." It would clearly prefer if the Australian dollar headed lower. Some think it will with ANZ Bank, National Australia Bank and Westpac, for example, believing the Australian dollar will be down in the low USD 0.70s by the end of next year. But it is by no means a given with the Australian dollar currently clearly in favour with investors. Commonwealth Bank thinks a more likely outcome is that we will see even more buying, with the Australian dollar rising to USD 0.85 by the end of next year. "Anything might happen" may not be terribly helpful guidance to anyone, and foreign exchange forecasting is fraught at the best of times, but currently, there is not much of a meeting of minds on the outlook for the Australian dollar.

Australian & International Property — Review

The A-REITs have had large swings in price during the year, principally because of changing expectations about likely rises in bond yields with original fears of large and early rises in bond yields subsequently revised to a less alarming outlook. An additional factor at play has been the general investor concern about the impact of e-commerce on the retail REITs, which have a large weight in the sector. The result is that the S&P/ASX 200 A-REITs Index has recorded a 4.3% year-to-date capital loss, and a 1.1% loss after including dividend income.

Like global equities more generally, world listed property shares took a series of hits in August and September as North Korea emerged as a geopolitical issue, but like the wider market, it has mostly shrugged off the concerns. Year to date, the FTSE EPRA/NAREIT Global Index in U.S. dollars has delivered a total net return (including taxed dividends) of 12.1%, which was a modest underperformance relative to the 15.2% net U.S. dollar return from the MSCI World Index. Among the major markets, the eurozone stood out with a 24.2% net U.S. dollar return, due to both firming economic activity in the eurozone and a higher euro. North American markets contributed only a small 3.7% return, while Japan detracted from performance with a 4.2% net loss.

Australian & International Property — Outlook

The ongoing slower-than-usual pace of national economic growth is reflected in property outcomes, with some strong sectors and regions offset by weak conditions elsewhere. As Colliers' latest research report on the CBD office markets showed, for example, conditions vary from very strong in Sydney and Melbourne—Colliers reckon that net effective rents for premium offices in Sydney will rise by 14.2% in the year to next June, and by 10.6% in Melbourne—to very weak. Colliers expects the office vacancy rate in Perth will still be over 20% in June next year, and vacancy rates will also be high in Adelaide (15.5%) and Brisbane (14.1%).

The subpar growth of the economy is also holding back the retail sector. As Morningstar's September quarter *Earnings Insights* report said, "The issue facing SCG [mall owner Scentre Group] and other retail landlords is the inability or reluctance of households to increase their annual spending as they have in the past. Australian households face challenges of rising indebtedness, reduced job security, and wages growth at an 18-year low." The retail sector also faces the longer-term challenge of e-commerce.

On most metrics, the A-REITs offer reasonable value. By historical standards, A-REIT prices are at fair value relative to the net tangible asset value of the properties they own; the price/equity ratio on the sector relative to the P/E ratio on the S&P/ASX 200 is on the cheap side, and the income yield relative to 10-year Commonwealth bonds is a bit more generous than usual. Nonetheless, the sector has continued to underperform both in absolute and relative terms. Some clear pickup in the rate of growth will need to

be visible before investors take a greater interest in the sector.

Global property has delivered good returns year to date, based on reduced fears of sharply higher bond yields and clear improvement in the pace of global economic growth, and barring any major geopolitical shock to equity markets, should continue to do well on ongoing demand for yield and improved operational performance.

However, there are two issues for the sector. One is the scale of the threat from e-commerce to the retail subsector. While this is only beginning to become a serious issue for the likes of Australian and New Zealand mall owners, it is at an advanced stage overseas, particularly in the U.S. The U.S. FTSE/ NAREIT sectoral subindices show a remarkable picture: year to date, at end August, the retail sector has delivered a loss of 11.4% (shopping centres down 14.5%, regional malls down 13.6%), while the industrial sector has boomed (up 19.25%) as it has delivered the e-commerce logistics. Investors will need to be careful about subsectoral exposures. The other issue facing listed property is the low yield—a pre-tax 3.69% on the Global index. It may have its appeal when substantial rises in bond yields appear unlikely, but it remains vulnerable if investors return to brooding about more competitive fixed interest alternatives.

Australian Equities — Review

Australian shares have continued to drift sideways, and are still close to where they started the year: year to date, the S&P/ASX 200 Index is up a marginal 0.5% in capital value, though the return is a more respectable 4.1% after including dividend income. By sector, year to date, the industrials have done best (9.6% capital gain) though they too have drifted since midyear, followed by the globally popular IT sector (9.3%) and the miners (8.9%) who have benefited from higher export prices. The large financials sector (down 2.9%) has, however, held back overall performance, as have shares linked to consumer discretionary spending (down 1.1%) and the A-REITs (also down 1.1%, as discussed earlier in their own section).

Australian Equities — Outlook

The latest indicators have been mixed, and business surveys are not showing a clear picture. The Australia Industry Group's purchasing manager indices, or PMIs, of manufacturing, services and construction would suggest that all three sectors accelerated in August with manufacturing in particular doing very well. As AIG noted, "This was the highest monthly result for the Australian PMI® since 2002." On the other hand, the very similar style surveys of manufacturing and services run by the Commonwealth Bank found that both sectors, while still growing, had slowed down in August, and the CBA manufacturing survey found nothing like the surge in the AIG one: "Growth of Australia's manufacturing sector was sustained during August, but at the slowest rate for a year."

NAB's August business survey also had mixed results. On the positive side, actual business conditions (trading, employment, profits) have been doing fine: "Business conditions rose by 1 point in August to hit +15 index points, which is the highest level for the series since early 2008 and is significantly higher than the long run average level." But businesses are not happy, saying: "The sharp drop in business confidence this month is somewhat concerning, although the deterioration may prove to be short lived." NAB had a go at probing for the reasons, by separately asking those who were more confident and those who were less confident what was on their minds, but the exercise left us little the wiser. Both optimists and pessimists picked the same top two reasons in the outlook for their business, and pressure on margins, suggesting that there is indeed still a patchy pattern of overall business activity.

It has not helped that consumer confidence remains underwhelming. The latest (September 12) ANZ Bank/Roy Morgan Consumer Confidence Rating found confidence had slipped, and that "The weakness was broadly based, with a sizeable decline in households' perceptions of the economic outlook driving the deterioration in sentiment."

Similarly, the September Westpac/Melbourne Institute consumer survey found "the consumer mood remains downbeat...Pressures on family finances, concerns around interest rates, deteriorating housing affordability and rising energy prices have all weighed on confidence in 2017. These factors are more than offsetting the boost from an improved outlook for jobs."

It is possible that, underneath the mix of economic signals, the economy may be picking up speed. August's jobs news was certainly very positive. There was a 54,200 increase in employment in the month, which was well above the modest 15,000 or so that economists had expected, and it was very largely in full-time jobs (40,100). The unemployment rate held steady, at 5.6%, and even though there were more people coming into the workforce, the extra jobs available hoovered up the extra people looking for one. But it is still only one straw in the wind, and for the time being, the sharemarket's sidewise trading still accurately reflects an economy that has failed to break definitively out of its post mining boom slow patch. It will take some stronger evidence of a clear acceleration in business activity before equity investors are likely to see improved outcomes.

International Fixed Interest — Review

The biggest influence on global bonds in recent weeks has been the tension over North Korea, which has led during more nervous periods to "safe haven" buying of government bonds. In the U.S., for example, the yield on the benchmark 10-year Treasury note had been trading around the 2.25% mark in the first half of August, but got as low as 2.04% on September 7. There were similar North Korea-induced declines in other major bond markets, with the yield on the 10-year German government bond falling to a low of 0.30% (also September 7) and the yield on the Japanese equivalent dropping below zero (September 8).

More recently the bond markets appear to have become somewhat less worried about North Korea and yields have risen again with, for example, the U.S. benchmark yield now just under 2.2%, not quite back to its levels before the tensions emerged. Whether the more relaxed mood will persist is unclear. At the time of writing, the North Koreans had just fired another missile. But in any event the safe haven buying to date, with potentially more on the horizon, has led to modest capital gains for bonds.

While the economic fundamentals have temporarily taken a back seat to geopolitics, they have also helped the positive fixed interest outcome, with forecasters now inclined to think future monetary policy tightening, particularly in the U.S., will be slower and smaller than previously thought.

The result is that fixed interest has done well. Year to date, in terms of unhedged U.S. dollar total return, the Bloomberg Barclays global aggregate indices show that global government bonds have returned 7.5%, global corporate bonds 7.8%, emerging market debt also 7.8%, and global high yield (low credit quality) 9.5%.

International Fixed Interest — Outlook

Conditions in global bond markets remain highly unusual, with investors finding very little yield on offer. In the past week, for example, the Austrian government has been able to raise euro 4 billion (AUD 6.0 billion) at a yield of negative 0.165%, and investors looking for a positive yield are still being forced to go to unusual lengths to find it. Austria also issued another bond in the same week, with a 100-year maturity, on a yield of 2.1% and press reports say there was strong investor demand. Investors have also been forced into higher-risk and off-the-beaten-track options. Corporate treasurers have been delighted to supply the demand. According to U.S. data company Dealogic, some USD 340 billion of high yield debt has been issued year to date, which is a 38% increase on a year ago.

These unusual conditions have repeatedly wrongfooted previous expectations of bond yields moving back to more normal levels, and have persisted longer than practically anyone imagined. That said, there is now more solid backing for the view that conditions are finally on the turn, as central banks finally start to remove the ultra-supportive

monetary policy that had kept bond yields abnormally low for so long.

The key central bank is the Federal Reserve, or Fed, in the U.S. While U.S. inflation has generally been running lower than preferred, and has needed more of an enduring fillip from the Fed than originally anticipated to get back to 2%, it now looks as if monetary policy will be gradually nudged further away from its present very stimulatory setting. The Fed is scheduled to meet on September 19-20, and currently it is expected at that meeting to outline its plans for winding back the scale of its bond buying quantitative easing, or QE, programme, which has been keeping bond yields low. The Fed is also expected to raise interest rates a bit more from the current federal-funds rate target range of 1.0-1.25%, although more slowly than previously thought. Currently, the market expectation is that there is a 50:50 chance of the next increase happening at its December meeting. Forecasters consequently expect a gradual rise in bond yields, with the latest (September) *Wall Street Journal* poll of U.S. economic forecasters expecting the 10-year Treasury yield to rise to 2.6% by the end of this year and to 3.0% by the end of 2018.

The Bank of England, or BoE, in the U.K. is also moving towards tightening. Unusually, it is a rare example of a central bank where inflation is above the official target (2.9% in August compared with the BoE's target 2%), and with unemployment at its lowest since 1975 (4.3% in the May-July quarter), the bank said at its September 14 policy meeting that "some withdrawal of monetary stimulus is likely to be appropriate over the coming months in order to return inflation sustainably to target." The futures market now expects a 0.25% increase before the end of this year, whereas before the latest meeting, it had expected the first increase to come sometime in the back end of 2018.

The European Central Bank, or ECB, does not have the same inflation problem with eurozone inflation at 1.5% in August, below the ECB's 2% target, but given the improvement in the eurozone economy, it too has started to feel that ultra-supportive monetary policy is no longer needed. It has said that it will announce its plans for winding back its QE programme at its October policy meeting. Forecasters think the ECB is likely to taper, that is gradually reduce, the amount of bonds it buys each month over the course of 2018, and may not be buying any more bonds at all by end of year.

Geopolitics might yet throw a large spanner into the works, and monetary policy might not be able to proceed in the nice orderly fashion currently expected. But if it is, of the major central banks, only the Bank of Japan looks set to continue with indefinitely easy monetary policy: the others will be carefully, and gradually, moving from very easy policy to less so. The good news for investors is that modestly higher yields are on the foreseeable horizon, with the bad news that it will take a period of capital losses to get there.

International Equities — Review

World equity markets took a hit in August as geopolitical tensions heightened about North Korea's nuclear weapons programme, but recovered in September despite the ongoing issues. At the time of writing, North Korea had just fired another missile. Year to date, the MSCI World Index of developed markets equities is up by 9.5% in the markets' own currencies, and by 13.5% in U.S. dollar terms, as the U.S. dollar has been globally weak.

The U.S. market has led the developed markets, with the S&P500 Index up 11.7% in year-to-date capital value. American shares have benefited from the ongoing growth of the U.S. economy, but have also been helped by strong investor interest in two sectors where American companies are dominant: tech and biotech. Year to date, the computer-related stocks listed on the NASDAQ Exchange are up 27.5%, and the biotech companies up 25.2%.

European shares have generally done well, particularly since the end of August, on accumulating evidence of stronger eurozone economic growth. The FTSE Eurofirst300 Index is up 4.7%, with German shares up 9.0%, and French

shares up 7.2%. The U.K. market, mired in its Brexit process, has lagged, with the FTSE100 Index up a marginal 1.0%.

Emerging markets have been stronger again, with the MSCI Emerging Markets Index up 22.4% in the emerging markets' currencies and by 27.8% in U.S. dollar. The key BRIC markets have done very well. Brazil's sharemarket has been exceptionally strong, up 25.8% year to date, and Indian shares are not far behind, with a 21.2% rise. China's Shanghai Composite Index has performed well since midyear, and is now up 8.1% year to date. Russian shares are now roughly all square for the year: prices dropped sharply in the first half of the year but have recovered since mid-June. Year to date, the FTSE Russia Index, which is denominated in U.S. dollars, is now up 0.8%, though the alternative RTS Russia Index, also U.S. dollar-denominated, shows a small 2.5% loss.

International Equities — Outlook

On the economic front, the outlook remains positive. The latest (August) J P Morgan Global All-Industry Output Index shows a good pace of global economic activity: "Overall growth was the quickest since April 2015, underpinned by expansions across the six main categories of manufacturing and services covered by the survey. With new order inflows strengthening, backlogs rising and jobs growth accelerating, the economy looks set to perform well in the coming months." By sector, the index also showed that technology, and pharmaceuticals and biotechnology, in particular, are the fastest growing sectors, which shows that there is a fundamental underpinning for the sectors' recent popularity with investors.

Forecasters are also upbeat. The *Economist* in London surveys a panel of international economic forecasters every month, and its September poll showed that every one of the 25 countries in the survey is expected to grow in 2018. The emerging markets are expected to be particularly strong, with India expected to grow by 7.5% (up from an already impressive 7.0% for this year) and China by 6.5%. The *Economist* also makes its own forecasts for countries outside the most important 25: every single one of them is expected to grow in 2018, other than grossly misgoverned Venezuela.

This would normally be clearly supportive for world equities, but one significant qualification is that the positive outlook is already well built into prices, particularly in the U.S. which is the most expensively valued of the major markets. Currently, the share market analysts surveyed by U.S. data company FactSet have ambitious expectations for American shares in that they expect profits for the companies in the S&P500 Index to grow by 11.0% in 2018, and the index to rise by 10% over the next year. This is achievable given the ongoing growth in the U.S. economy, but it also leaves little leeway for earnings disappointments if companies, or the economy more generally, do not live up to expectations. One possible flashpoint could be Congressional impasse over the Federal government's debt ceiling. Currently dysfunctional politics have managed only a short-term patch to the end of December, and the threat or reality of inadvertent fiscal tightening could become a problem for investors later this year.

Another potential issue is mis-steps by one of the major central banks in withdrawing the current degree of monetary stimulus. As noted earlier, all the central banks look to be approaching the process with a high degree of caution and care, but the equity markets have been roiled by a "taper tantrum" before, and might be hit again.

Economic considerations may however take a back seat to geopolitics in coming months. Nobody knows how the current North Korean difficulties will play out, or whether currently quiescent hot spots in the Middle East or the Ukraine (among others) will stay that way. Investors (going by the VIX gauge of expected S&P500 volatility) are either robustly confident (on a positive view) or blindly complacent (on a negative view). The VIX has recently signalled some degree of investor nervousness with it spiking twice in early- to mid-August and again in early September, but the equity market showed remarkably

small levels of alarm given the potential threats from a nuclear-armed, hostile and erratic North Korean regime. The rise in the VIX, for example, was not especially large (the markets were less worried, for example, about nuclear North Korea than they had been in early 2016 about a potential slowdown in the Chinese economy), and did not last, with the VIX now back to "all clear" levels.

All going well, the clear evidence of a strengthening world economy will carry the day, and global shares will be able to make further gains. But there is a higher than usual probability of left field geopolitical surprises making their presence felt. That may well be why the big fund managers in the latest (early September) Bank of America Merrill Lynch survey reported increased levels of insurance protection against equity market corrections in the next three months.

Performance periods unless otherwise stated generally refer to periods ended 15 September 2017.

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